DE NEDERLANDSCHE BANK N.V.

Policy rule on key principles for assessing the risk management for alternative investments

Policy rule of De Nederlandsche Bank N.V. of 1 August 2007, no. Juza/2007/01410/IH providing key principles for assessing the risk management for alternative investments of financial undertakings and pension funds. (Policy rule on key principles for assessing the risk management for alternative investments)

I INTRODUCTION

Alternative investment forms, such as (funds of) hedge funds and private equity, are attracting ever more interest. Institutional parties are placing a growing share of their capital in such asset categories. The increasing activity of institutional investors in alternative investments and the potential risks flowing from these products justify specific attention from the prudential supervisor of financial undertakings and pension funds.
DNB has formulated a number of key principles to aid the assessment of risk management for financial undertakings and pension funds. These principles have been made available to the sector in this policy rule as a reflection of DNB's wish to exercise its supervision in a transparent manner.
The key principles are aimed at risk management for alternative investments, in particular the less liquid and/or less transparent high-risk investment vehicles. These mainly involve investments through direct participation in alternative investment funds or participation in umbrella funds.[1] Cases in point are investments in private equity or hedge funds, but also other forms of alternative investments, such as infrastructure, microcredits, etc. As such this document is relevant above all to the supervision of banks, investment firms[2], insurance companies and pension funds.

1.1 Nature of the supervision

1.1.1 Legal framework

The relevant regulations relating to risk management for alternative investments can be found in, for instance, the Financial Supervision Act *(Wet financieel Toezicht /* Wft*)* the Pensions Act *(Pensioenwet)* and the Compulsory Occupational Pension Scheme Act *(Wet verplichte beroepspensioenregeling)*. These regulations concentrate on investment policy, outsourcing and operational management. For banks, investment firms and insurers, the provisions relating to operational management and outsourcing are included in Sections 3:17 to 3:18a of the Wft and in subsection 4.2 (Risk management) and the (other provisions of) Chapters 4 and 5 of the Decree on Prudential Rules for Financial Undertakings *(Besluit prudentiële regels Wft)*. For pension funds, these rules are contained in articles 34 and 143 of the Pensions Act and 43 and 138 of the Compulsory Occupational Pension Scheme Act, Chapter 4 of the Decree on implementing the Pension Act and the Compulsory Occupational Pension Scheme Act and Section 8 of the Decree on the Financial Assessment Framework for Pension Funds.
This policy rule follows partly from the European Pensions Directive and the new pension acts which are based on the 'prudent person' principle. Alternative investments are allowed as long as they are consistent with this principle. A similar approach applies for insurance companies, where alternative investments are allowed under certain conditions as cover for technical provisions. Under the second pillar of Basel 2, banks and investment firms are expected to adequately manage all the risks to which they are exposed, including risks arising from alternative investments.

1.1.2 Principles-based supervision

DNB applies a principles-based approach in its supervision. This allows the supervision of risk management for alternative investments to respond to the wide range of alternative investment opportunities and the associated differences in the elaboration of risk management. The consequence of a principles-based approach is that financial undertakings or pension funds

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1 Increasingly institutional investors are also supplying alternative investment funds with borrowed capital (for instance through participation in a syndicate or through investments in securitised loans). The specific risks of such constructions fall outside the scope of these key principles. The document is not concerned with bank lending either.

2 This policy rule is only relevant to investment firms insofar as they are subject to the Basel 2 solvency rules (or, up to 1 January 2008, the Basel 1 rules)

themselves work out their own alternative investment policies in a responsible manner. In this policy rule, the principles, as laid down in legislation and regulations, are translated into a number of key principles that DNB applies in assessing whether financial undertakings or pension funds observe these principles. The key principles cover different areas, such as strategic investment policy, outsourcing policy and communication policy.

1.1.3 Dialogue

It is the financial undertaking or pension fund's responsibility to conduct adequate risk management for alternative investments and to comply with the statutory provisions. With the help of the key principles outlined in this policy rule, the supervisor (DNB) will assess whether the financial undertaking or pension fund has conducted its risk management for alternative investments adequately. It is up to the financial undertakings and pension funds to demonstrate to the supervisor, through dialogue, that this is the case or (in the event of shortcomings) that risk management will be raised to an adequate standard as a matter of urgency.

The key principles have been formulated as an internal resource for supervisors and aim to provide starting points for the dialogue with the financial undertakings and pension funds involved. The principles are a collection of focus areas and best practices. Financial undertakings and pension funds may diverge from the key principles and best practices if circumstances give them cause to do so, and if risk management can thus be conducted more appropriately (as intended by legislation and regulations). At the same time, however, there may also be aspects that actually justify a further definition of risk management. The key principles are neither a necessary, nor a sufficient condition for complying with legislation and regulations. But in DNB's view they should work well in many practical situations.

1.1.4 Proportionality

An important aspect of the assessment is the notion of proportionality. This entails that the conduct of risk management for alternative investments fits in with the specific situation of a financial undertaking or pension fund and the form and nature of the risks stemming from alternative investments. This does not mean that lower standards will be applied to small, simple financial undertakings and pension funds. But it does mean that there will be differences among financial undertakings and pension funds in the practical application of risk management.

1.1.5 Risk-based supervision

In accordance with the basic principles of risk-based supervision, DNB's supervisory efforts will be concentrated – as illustrated in figure 1.1.5 – in those areas where the likelihood of problems arising will be greatest and the impact of problems is expected to be most extensive.

Figure 1.1.5

Growing risk, higher supervision requirements		*Higher supervision intensity*	
Small share of fund assest in alternative investments	Large share of fund assets in alternative investments (e.g. >5%)	Institution with advanced risk management and extensive knowledge	Less advanced institution with no experience in alternative investments and with limited capacity and systems
Investments in fund of funds	Investments through direct participations	Institution with large capital base / solvency buffer / funding level	Institution with small capital base / solvency buffer / funding level
Investments with reputable manager	Investments with new manager / strategy		
Investments aimed at lower-risk strategies	Investments aimed at higher-risk strategies		

1.1.6 Outsourcing

To a greater or lesser extent, financial undertakings and pension funds often outsource activities relating to risk management. Outsourcing involves a financial undertaking or pension fund arranging for activities to be carried out by third parties, including other companies within the group to which the financial undertaking or pension fund belongs. Certain administrative tasks relating to portfolio management can be outsourced, for instance. In the case of outsourcing, the financial undertaking or pension fund needs to ensure that the third party in question complies with the rules applying to the financial undertaking or pension fund. The outsourcing financial undertaking or pension fund therefore remains responsible for adequate risk management. In fact, in the event of outsourcing, a financial undertaking or pension fund's own risk management will focus more heavily on the selection process, the negotiation of a sound contract, and the assessment and monitoring of (the risk management) processes and other aspects of the parties to which tasks have been outsourced.

For the supervisor, the financial undertaking or pension fund itself remains the point of contact. The basic principle is that the financial undertaking or pension fund remains in control. One of the key issues is what measures are in place to ensure that the party to which tasks are outsourced conducts risk management for those tasks in a manner that is adequate (for the financial undertaking or pension fund). Of course the risk management at the level of the financial undertaking or pension fund also needs to be sufficient. If on the basis of the information obtained from the outsourcing financial undertaking or pension fund or on some other basis, it is not possible to determine whether the obligations for adequate risk management are being fulfilled in respect of the subcontracted activities, then the supervisor may decide to conduct further investigations at the parties to which tasks have been delegated. This will only be done, however, if there are no other ways of determining whether risk management is adequate.

1.2 Other points of attention

- Although the key principles explicitly focus on the risk of alternative investments, this does not mean that a limited allocation to alternative investments will automatically be associated with a disproportionate increase in the risk profile. Nor are all alternative forms of investment characterised by a high risk profile or illiquidity. 'Traditional' investment forms may intrinsically carry a similar or even a higher risk.
- The key principles do not make an explicit distinction between the various investment categories. Although it is not that easy to identify a common denominator among the alternative investment forms, there are considerable similarities in the risk management associated with them. That is why risk management is discussed as a whole and in general terms here.

2 Eight key principles for assessing risk management for alternative investments of financial undertakings and pension funds

Characteristics of alternative investments

► *Key principle 1: The assessment of alternative investments takes appropriate account of the specific risk and return characteristics of these investments.*

Alternative investments are generally characterised by a divergent, asymmetric risk profile, limited transparency and illiquidity. Funds often observe minimum holding and notice periods. In addition, closed-end fund structures are usually less liquid than open-end funds. Historical return figures are also often distorted or not representative. Furthermore, a number of risks are particularly relevant to alternative investments: liquidity risk, operational risk, reputation risk, and risks arising from outsourcing. For these reasons traditional risk indicators often fail to give an adequate and comprehensive picture of the risks of alternative investments.

Portfolio policy

► *Key principle 2: Alternative investments fit in with the financial undertaking or pension fund's overall strategy, due account being taken of the financial undertaking or pension fund's total risk profile, including the relation between alternative investments on the one hand and the total investment portfolio and the nature and extent of the liabilities on the other hand.*

Through the use of suitable infrastructure (capacity, systems), the divergent characteristics of alternative investments can be given due consideration. On the basis of risk analyses it is possible to decide whether alternative investments fit in with the nature and extent of the liabilities. Other aspects that play a role in strategic investment choices include: the investment structure (umbrella fund or own management), the required liquidity, costs, but also the required knowledge level. The required knowledge can be obtained in part by calling on external parties.

► *Key principle 3: Financial undertakings and pension funds check at regular intervals that the diversification across investment strategies is adequate, thus avoiding undesirable concentrations in the portfolio.*

A sufficient diversification of the investments is essential, both within the total portfolio and within the portfolio of alternative investments. The return and risk characteristics of investments, including the extent of risk spreading, can be decided in advance within the framework of the strategic investment policy. The selection process with regard to alternative investments can then be brought in line with the strategic investment policy. In addition to quantitative factors, qualitative factors will also play a role in this context.

Due diligence

Alternative investment funds are often based offshore and subject to little supervision, if any. That is one reason why an adequate due diligence investigation may be of the utmost importance. The due diligence investigation is the most important process stage with regard to investments in alternative investment funds and requires specific expertise.

► *Key principle 4: The financial undertaking or pension fund analyses at regular intervals the risk profiles of the investment strategies and the capacities of the managers of the funds in which the institution has invested or intends to invest. The analysis is based on timely and sufficient information about the funds and their managers, so that an independent assessment can be made.* It is impossible to provide an overview of all aspects which require attention in the due diligence process. What matters is the overall picture. However, the points of attention can be broadly divided into: people, processes and performance. Due diligence also includes an assessment of the fiscal and legal aspects of the proposed investments. The assessment of people looks at both management and staff. A major aspect in this context is the integrity risk. The assessment of processes looks at such factors as the organisation of the investment fund, risk management, the investment process and the processes surrounding any outsourcing to third parties. An assessment of the performance includes, if possible, an analysis of the management's track record. An important aspect in this context is the way in which the fund valuation is effected. The quality of the disclosed information is very important.

► *Key principle 5: The reports provided by (funds of) funds use proper valuation principles, are submitted in time, and have sufficient quality assurance. The financial undertakings or pension funds hold sufficient information about the underlying funds.*
If the institution participates in umbrella funds, then the due diligence process should consider several additional aspects, arising from the introduction of an additional management layer.
► *Key principle 6: An assessment of funds of funds also includes a judgement of the quality of risk management conducted by the fund of funds manager and the standards and criteria of conduct observed.*

Contract terms and monitoring
► *Key principle 7: Alternative investments cannot do without adequate contract terms. Broadly speaking, these provide for an unambiguous limitation of risks, the measures to be taken in case of thresholds being crossed, adequate disclosure, a clear description of lock-up periods, and explicit cancellation and termination conditions. Compliance with the contract terms is monitored systematically.*
It is not possible to suggest an optimum set of contract terms. The key point is the demand that a financial undertaking or a pension fund must be able to conduct adequate risk management. The financial undertaking or pension fund must come to a constellation of agreements, which leaves the financial undertaking or pension fund as a whole in control. By assuring a limited liability structure, the financial undertaking or pension fund can protect itself against liability risks.
Alternative investments cannot be regarded as passive investments. In order to ensure optimal operational flexibility in the financial markets, many alternative investment funds decide not to clearly define their strategies in their prospectuses. By checking the performance of the fund and the fund managers frequently and actively and by verifying the compliance with agreements, the institution can intervene at an early stage, if necessary, and where possible. The facility for adequate intervention can prevent serious losses, and so merits attention in both the selection and monitoring process. The more difficult the fund's structure makes it to intervene and the more restricted the liquidity of investments, the greater the importance of adequate due diligence and control mechanisms. The monitoring process covers not only investment aspects but also operational matters.
When a financial undertaking or pension fund participates in a fund of funds, the monitoring process is outsourced to some extent. In that case, the financial undertaking or pension fund's focus will shift from the underlying securities to the fund of funds.

Communication
Finally, we note that the operation of alternative investment funds is the subject of public debate. Some parties have a reputation of seeking short-term financial gains while ignoring broader, long-term interests. There is a danger that this negative image reflects on end investors in these funds. *Key principle 8: For the adequate management of its own reputation risk, the financial undertaking or pension fund is clear and plain in its communications with interested parties about the reasons for its policy regarding alternative investments and the objectives which it seeks to achieve in this respect.* A sound investment policy is paramount here. Investment decisions may be difficult to communicate but nonetheless desirable or necessary.

3. FINAL PROVISIONS

This policy rule shall be referred to as: Policy rule on key principles for assessing the risk management for alternative investments.

This policy rule will be posted on the website of De Nederlandsche Bank N.V. (www.dnb.nl). This posting will be announced in the *Staatscourant*[3]

De Nederlandsche Bank N.V.

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3 Government Gazette.